

## MEMORANDUM

TO: Kentucky State Chartered Banks

FROM: Cordell Lawrence  
Executive Director

RE: Senate Bill 45/Predatory Lending

DATE: May 19, 2006

The 2006 Kentucky General Assembly passed Senate Bill 45, which resulted in several changes to Chapter 287 of the Kentucky Revised Statutes. One of the changes involved the state's super-parity law, KRS 287.102. This change now allows state-chartered banks to be exempt from any statutes or regulations which would be pre-empted for other banks or thrifts. The primary area that is pre-empted is in the arena of residential real estate lending, specifically state predatory lending laws.

Banks that choose to make loans that conflict with the requirements of KRS 360.100 must follow any directives issued by the Office of the Comptroller of the Currency (OCC). In January 2004, the OCC issued a final rule that essentially preempted the application of portions of KRS Chapter 360 to national banks, in the belief that the chapter obstructed or impaired a national bank's ability to engage in lending activities. In particular, the "high-cost" lending provisions, found in KRS 360.100, would be subject to this final rule. As a result, national banks are exempt from limitations contained in this statute.

The OCC has issued guidelines and advisory letters in the past several years that are worthy of mentioning in this memorandum. These directives outline certain activities, according to the OCC, which either constitute or under certain circumstances may constitute "predatory" lending practices, and the regulatory expectations on how national banks should respond to combat these unacceptable practices.

Some examples of unacceptable practices considered predatory in nature include: loan flipping; refinancing of special subsidized loans that result in the loss of beneficial loan terms; equity stripping; and packing of excessive and sometimes hidden fees in the amount financed. Other loan terms and features, which may under certain circumstances be considered abusive or predatory, include, but are not limited to: using balloon payments to conceal the true burden of the financing; forcing borrowers into costly refinancing transactions or foreclosures; targeting inappropriate or excessively expensive credit products to older borrowers; inadequate disclosure of the true costs, risks, and where necessary, appropriateness to the borrower of loan features and terms; financing single premium credit insurance; prepayment penalties; negative amortization; and the use of mandatory arbitration clauses. These loan terms or features may, under certain circumstances, be subject to predatory or deceptive practices; however, could be appropriate risk mitigation measures and benefit customers under other circumstances.

The regulatory community expects commercial banks, regardless of charter choice, to implement prudent procedures and practices to combat the aforementioned abuses. Examples of sound practices include the following:

- 1) Adequate underwriting policies that require lending decisions based primarily on the repayment capacity of the borrower;
- 2) Policies that address the risk of abusive practices, such as the use of single premium credit life insurance financing, and the circumstances when these products are appropriate; and
- 3) Loan quality control reviews.

There is currently no evidence that Kentucky state-chartered banks are engaging in practices that would be considered predatory in nature. However, this agency has a fiduciary responsibility to ensure that banking transactions are conducted in a safe, sound, and fair manner, and the consumers of the respective institutions are treated fairly.

At upcoming regulatory examinations, agency examiners will be requesting specific information in addition to regular documentation requests. For example, one of the items to be requested will be a listing of all loans generated that have single premium credit insurance financed as part of the lending transaction. If a large volume of loans with this type of financing are identified, bank management will be responsible for articulating why this type of product was beneficial to the borrower, and what other alternative products were considered but not utilized. Other regulatory requests may be developed and utilized as a way for this agency to ensure that no predatory lending practices are prevalent in the banking industry.

This agency will also be using the directives from the OCC as a baseline in approaching regulatory supervision in this area. Bank Management should become familiar with the contents of these directives. I welcome your comments and feedback. Working together, we can promote a safe and sound banking environment in Kentucky.

The OCC issuances can be found at: <http://www.occ.treas.gov/ftp/advisory/2003-2.doc> and <http://www.occ.treas.gov/fr/fedregister/70fr6329.pdf> . Please e-mail [david.coyle@ky.gov](mailto:david.coyle@ky.gov) should you want copies emailed to you. Please contact David Coyle at (502) 573-3390, Ext 277, or Ken Pennington, Ext 248, should you have any questions.